Inspira-Journal of Commerce, Economics & Computer Science (JCECS)
ISSN : 2395-7069 General Impact Factor : 2.0546, Volume 03, No. 04, Oct.-Dec., 2017, pp. 189-192

IMPACT OF DEMONETIZATION ON LIQUIDITY IN BANKING SECTOR

Dr. M.L.Sharma *
Meenakshi Gaur **

ABSTRACT

Demonetization is a tool to battle inflation & black money in an economy still the biggest beneficiary from demonetization will be the banking sector. The government's decision on November 8 2017 to immediately demonetize the Rs 500 & 1000 notes in circulation which is the total 86% of the value of currency in circulating has impacted all sectors. From a market perspective it has taken the black money holders surprise. The World Bank in July 2010 estimated the size of the shadow economy for India at 20.7% of the GDP and unlikely the post announcement of demonetization by the government this money would have to either account by paying the relevant tax and penalties or would get extinguished. Banks are intermediaries who play an important role in the supply of money in circulation. Hence they are the liquidity controller and manager of liquid funds.

KEYWORDS: *Banking Sector, Liquidity, Demonetization.*

Introduction

Demonetization is a process by which a series of currency will not be legal in future. The decision was bold relative to economic policy of the nation. This demonetization is Prime Minister Narendra Modi's attempt to reduce bribery and the black economy so that India may shift towards digitalized money transfers, which are more traceable and taxable. Secondary sources of data have been used for study which is collected from various journals, news bulletin, periodicals and online sources. Hence it can be concluded that apart from the problem in daily lives of a common man there are still bigger implications for the economy as a whole. It was found that as an impact of demonetization the interest rate may gone down, increases the employment opportunities and decrease in the price of the commodity of daily use. It means the liquidity is affected the most and if the liquidity effected then banking sector will not escape.

Demonetization is the act of stripping a currency unit of its status as legal tender. It occurs whenever there is a change of national currency: the current form or forms of money is pulled from circulation and retired, often to be replaced with new notes or coins. Sometimes a country completely replaces the old currency with new currency.

Objective

The major objective of the study is to find out the impact in the form of pros and cons of the decision taken by the Indian government on demonetization of the 1000 and 500Rs. currency notes on the liquidity of the of banking sector which is the backbone of the Indian economy. The following are the specific objectives of the study.

---

* Associate Professor, Department of Economic Administration and Financial Management(EAFM), Faculty of Commerce, University of Rajasthan, Jaipur, Rajasthan, India.

** Research Scholar, Department of Economic Administration and Financial Management(EAFM), Faculty of Commerce, University of Rajasthan, Jaipur, Rajasthan, India.

- To enlighten the good and bad impact on the liquidity of banking sector of the demonetization.
- To analysis the decision in form of increment or decrement of liquidity.
- 1000 and 500 were out of circulation and its effect on liquidity.

CASA: It is the ratio which indicates how much of the total deposits with the banks are in the current account and saving account or the deposits legging in the savings and current accounts. The December quarter saw the CASA ratio of banks increase between 5% and 10%.

Advantages

- Increase in CASA (current account and saving account) deposits for most banks while landing rates to drop further. Due to demonetization the deposits in the bank will increase and that will increase the CASA, and net interest increase and not earning of the banks will increases. This way the banks get funds at very low cost because banks gave no interest on current account and very low interest on saving account deposits. Banks get a lot of liquidity hence borrowing cycle will be increase at the lower rate of interest.
- The biggest advantage of the demonetization is on the Jan Dhan Yojana bank accounts which showed an increment in their cash deposits.
- The reserve banks come to know about its currency flowing in the market and now to able to have a dog watch on currency transaction.
- The uses of credit cards and debit cards were highly increased in making payments and new debit card and credit cards were also issued.

Negative Impact

- In the payment cycle of NBFCs and MFIS they bear the maximum stress as they have to deposits their collections in the form of cash.
- This demonetization impact also the banking revenue cycle as the revenue yielding operation (RYO) like vending loans (issuing new loans or login new loans) and cross selling investment products (CSIP) have taken a back seat in most banks.RBI has announced incremental CRR (cash reserve ratio) of 100% on the growth in bank deposits between 16th September 2016 and 11th November 2016. The entire incremental deposits in the given period have to be paid on CRR ,while banks will have to give (shell out) up to 4% interest on the funds received in saving deposits. Hence the positivity changes into the negativity.

Liquidity Increment and Decrement

Liquidity conditions as per the RBI records it can be divided into four phases: With the return of SBNs to the banking system, while currency in circulation contracted, deposits in the banking system surged. The sudden increase in deposits (given the gradual replacement of SBNs by new notes) created large surplus liquidity conditions in the banking system, which could be divided into four distinct phases in terms of how liquidity was managed by the Reserve Bank using different instruments. The active liquidity management was necessitated to ensure that the operating target remained aligned to the policy repo rate.

- In the **first phase** (November 10 to November 25), the Reserve Bank absorbed the excess liquidity through variable rate reserve repos of tenors ranging from overnight to 91 days under its Liquidity Adjustment Facility (LAF). The outstanding amount of surplus liquidity absorbed through reverse repos (both variables rate and fixed rate auction) reached a peak of Rs. 5242 billion on November 25.
- In the **second phase** (November 26 to December 9), the liquidity surplus was managed through a mix of reverse repos and the application of the incremental cash reserve ratio (ICCR) of 100 percent on the increase in net demand and time liabilities between September 16 and November 11, 2016. The ICCR helped drain excess liquidity in the system to the extent of about Rs. 4000 billion during the fortnight ended December 9, 2016.
- In the **third phase** (December 10 to January 13), surplus liquidity conditions were managed through a mix of reverse repos and issuances of cash management bills (CMBs) under the MSS. With the enhancement of the limit on issuance of securities under the MSS from Rs.300 billion to Rs. 6000 billion on December 2, 2016 by the Government of India, the Reserve Bank withdrew the ICRR effective the fortnight beginning December 10, 2016. Between December 10,

2016 and January 13, 2017, surplus liquidity in the system was managed by a mix of fine – tuning reverse repo operations and auctions under the MSS. The peak liquidity absorbed was Rs. 7956 billion on January 4, 2017 (2568 billion absorbed through reverse repos and Rs.5466 billion through CMBs). Subsequent to the advance tax payment in mid- December, a part of the excess liquidity was offset by the build-up in government cash balances. The surplus liquidity in the system declined to Rs. 7269 billion on January 13, 2017.

- In the **fourth phase** (since January 14), the Reserve Bank has increasingly used reverse repo operations to absorb surplus liquidity, particularly the liquidity released through the maturing CMBs, as the magnitude of surplus liquidity has been moderating in sync with re-monetization . Of the total surplus liquidity (net of injection under the LAF) in the system of Rs. 5537 billion on March 7, 2017, Rs.500 billion was absorbed through CMBs under the MSS and the remaining through variable rate reserve repo auctions under the LAF.

The surplus liquidity is expected to decline going forward as re-monetization progresses further, which will result in decline in deposits with the banking system. Despite this, however, surplus liquidity conditions are likely to persist for some more time.

Liquidity in form of changes into lending rates

Surplus liquidity conditions have helped facilitate the transmission of monetary policy to market interest rates. Post demonetization, several banks lowered their domestic term deposit rates and lending rates. The median term deposit rates of SCBs declined by 38bps during November 2016-Feberary 2017, while the weighted average term increase in low cost CASA deposits, the overall cost of borrowings declined, allowing banks to reduce their lending rates. The weighted average lending rate (WALR) of banks in respect of fresh rupee loans has been declined by 56bps during November 2016-January 2017. During January 2017, 25 public sector banks reduced their 1-year MCLR in the range of 15 to 90bps, while 17 private sector banks reduced it in the range of 10 to i48bps. The 1-year median MCLR of SCBs declined by 55 bps during January 2017. During February 2017, six public sector banks lowered their 1-year MCLR in the range of 15 to 65 bps, while six private sector banks reduced in the range of 10 to 50 bps. During March 1-7, 2017, two private sector banks reduced their 1-year MCLR has in the range of 5 bps and 20bps. The 1-year median MCLR has declined by a cumulative 70bps since November 2016 even when the policy repo rate was not changed. This is significant, considering that the 1-year median MCLR declined by only 15 bps during the preceding seven months (april-october2016) when the policy repo rate was reduced by 50bps. The WALR on outstanding rupee loans declined by 8 bps during November 2016-January 2017 as against the decline of 11 bps during the preceding seven months (April –october2016).

Monetary Transmission: Reduction in Deposit and Lending Rates Post Demonetization (Up to March 7, 2017)

(bps)

Bank Group	MCLR (Median)	Term Deposit Rates (Median)		
	1 Year	Up to 1 Year	1 to 3 Years	All tenors
Public sector banks	85	26	35	28
Private sector banks	65	50	48	50
Foreign banks	40	8	34	6
Scheduled commercial banks	70	31	40	38

Source: 1 RBI MCLR: Marginal Cost of Funds based Lending Rate(march10,2017)

By the effect of demonetization 500 and 1000 Rs. were out of the system which creates the 86% of the currency circulation. It stops the liquidity in the whole economy but only for a short period. The currency denomination was changed by Rs. 500 and 2000 and further by 2000 and 50 Rs note. The impacts of these results on the persons or individuals who have saved the currency in cash form at their own houses. They were not able to stop the currency or the parallel currency that was out either in form of bank deposits or as wastage of paper.

The government record shows that the currency in form of 500 and 1000 rupees notes has collected almost issued, and the total expenses for issuing the new note was around rupees 2000 cr. was a burden to the economy but the revenue generated by the government in form of tax collection was more than the expenses news recording money and currency capturing period.

Conclusion

After taking notice of all the data, the impact and effect of demonetization on the liquidity of the banks and the individuals is found to be present. We can say that for a short period of time the liquidity is stucked. But the entry of reserve bank and the decision taken accordingly made it in a robust form. Still the profitability of the banks was increased government collected revenues in form of cash and banks converted their maximum accounts into digital forms. So the liquidity in forms of deposits and revenues of government increased, that's a good impact of demonetization on liquidity.

References

- Business world(BW).com
- Economic times.
- Financial express
- Investopedia.com
- Macroeconomic impact of demonetization-A preliminary Assessment(Reserve bank of India march 10,2017)
- http://taxguru.in/rbi/demonetization-effect-banking-sector.html#stash.uOs859u9.dupf
- taxguru.in/…/demonetization-effect-banking sector

❍❍❍